

# Fiscal Note

*Fiscal Services Division*



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**HF 2466** – Low Income Property Assessment Option (LSB 6206HV)  
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Fiscal Note Version – New

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## **Description**

**House File 2466** allows owners of property assessed using the special assessment procedures of [Iowa Code section 441.21\(2\)](#) to elect not to have the property assessed through the special assessment procedure. The election to forgo the special assessment procedure cannot be rescinded by the owner at a later date. The special assessment procedure involves rental housing constructed under Internal Revenue Code section 42 (low income housing tax credits). The change is effective beginning in assessment year 2015.

## **Background**

### *Terminology*

This document generally refers to the future in “fiscal years.” Fiscal year 2015 begins July 1, 2014, and ends June 30, 2015. Fiscal year 2015 is designated “FY 2015.” It is also referred to by some as FY 2014-2015. Property taxes in Iowa are determined based on “assessment years (AY)” but paid on a fiscal year basis. Property assessed as of January 1, 2015 (AY 2015), has taxes due in the fall of calendar year 2016 and the spring of 2017 (FY 2017).

Iowa’s property tax system is based on a mathematical rollback calculation that varies by property class. The term “rollback” refers to the percentage of a property’s assessed value that is subject to property tax. A property with an assessed value of \$100,000 that benefits from a rollback of 75.0% pays tax on \$75,000 of property value (\$100,000 times 75.0%).

Iowa’s general rule of property assessment is “market value,” the value that a property will sell for in a transaction between a willing buyer and unrelated willing seller. There are exceptions to market value assessment, and one of those exceptions is Section 42 housing.

“Section 42 housing” refers to a federal tax credit program that awards federal income tax credits to housing development projects that agree to rent housing units to income-qualified persons at below market rental rates. In return for offering lower rents, the developer/investors in the project receive annual federal Low Income Housing Tax Credits for a 10 year period.

The federal government allocates a set amount of Low Income Housing Tax Credits to each State annually and the annual allocation is generally based on the State’s population. Iowa’s allocation is administered and awarded by the Iowa Finance Authority.

### *Section 42 Property Tax Assessment*

Through FY 2014, rental properties with three or more units used as residences are taxed in Iowa as commercial property at or near 100.0% of market value. [Iowa Code section 441.21\(2\)](#) was amended in 2001 (SF 519 – Taxation of Property Rented to Low-Income Persons Act) to provide a special valuation procedure for Section 42 housing.

The relevant special assessment procedure for Section 42 housing reads:

*However, in assessing property that is rented or leased to low-income individuals and families as authorized by section 42 of the Internal Revenue Code, as amended, and which section limits the amount that the individual or family pays for the rental or lease of units in the property, the assessor shall use the productive and earning capacity from the actual rents received as a method of appraisal and shall take into account the extent to which that use and limitation reduces the market value of the property. The assessor shall not consider any tax credit equity or other subsidized financing as income provided to the property in determining the assessed value.*

That valuation procedure reduces the taxable value of Section 42 housing by excluding the value of federal tax credits and other subsidies owners receive when they agree to rent apartments at below market rental rates. The effect of the 2001 legislation was to establish taxable values for Section 42 housing that are below market value.

The special procedure for valuing Section 42 property is established in Department of Revenue rules. The special procedure provides for the capitalization of a three-year average of net operating income (gross revenue minus operating expenses) for each Section 42 property. The capitalization rate to be used each year is calculated as specified in the rule and provided to assessors by March 1 each year.

By law and by rule, the value of the annual federal income tax credits and other subsidies to the property owner in return for providing below market rents is not included as part of gross income, so the federal tax credit value is not part of the taxable value calculation for Section 42 property. However, federal income tax credits and other subsidies do bring revenue to Section 42 property, so these payments are important to the actual market value of the property.

Due to the 2001 legislation, Section 42 housing is always valued for tax purposes at less than market value. The percentage reduction below market value for a specific property depends on the amount of federal tax credits and other subsidies excluded for that specific property. Properties where the subsidies represents a large portion of the actual income stream of the property will be valued for property tax purposes well below market value, while other properties where the subsidies represent a smaller portion of the overall gross revenue will be taxed closer to market value.

*Senate File 295 – 2013 Session*

[\*\*Senate File 295 \(Property Tax and Income Tax Credit Act of 2013\)\*\*](#) provides for a staged rollback for properties classified as commercial, industrial, and railway. A fixed rollback percentage of 95.0% for FY 2015 and 90.0% for FY 2016 is required. For FY 2015 and FY 2016, current law provides that Section 42 housing is classified as commercial property and therefore will benefit from the staged rollback for that class. After FY 2016, Section 42 housing that continues to be classified as commercial property will continue to benefit from the rollback to 90.0%.

Senate File 295 also created a new property class called multiresidential and provided that class with a special rollback that phases in a lower taxable value for property in the new class. The class is created beginning in FY 2017 and at that time all properties classified commercial, but qualified as multiresidential, will transition to the new multiresidential class. Due to the pre-existing special valuation process, Section 42 housing is excluded from participating in the multiresidential classification and as a consequence will remain classified as commercial property under current law.

Beginning in FY 2017, properties within the new multiresidential class will benefit from a further staged rollback designed to lower the percent of market value that is subject to property tax over

a number of years. By FY 2023, multiresidential property will be taxed at 63.75% of its market value, and then for FY 2024 and after, multiresidential property will be taxed using the same rollback as residential property (currently projected to be around 58.0%).

Senate File 295 created a standing appropriation to reimburse local governments for the revenue loss associated with the reduced taxable value of commercial and industrial property that results from the taxable value reduction to 90.0%. Under the 2013 legislation, Section 42 housing does benefit from the rollback to 90.0%, so as long as Section 42 housing remains classified as commercial, and local governments will be reimbursed for the revenue loss created by the staged rollback to 90.0%.

However, the reimbursement appropriation from the State General Fund is capped at the FY 2017 level, meaning that if after FY 2017, the reimbursement claims from all local governments exceed the FY 2017 level, all claims will be prorated so that the total reimbursement does not exceed the FY 2017 level.

Senate File 295 also created a new business property tax credit to benefit properties classified commercial, industrial, or railway. Both Section 42 housing and properties in the new multiresidential class are excluded from participating in the new credit procedure, so the provisions of this Bill do not impact that tax credit.

### **Assumptions**

#### *Assessing the Likelihood of Section 42 Opt-out*

- The schedule for the multiresidential staged rollback established in SF 295 is:
  - FY 2015 = 95.00% (commercial)
  - FY 2016 = 90.00% (commercial)
  - FY 2017 = 86.25% (starts multiresidential class)
  - FY 2018 = 82.50%
  - FY 2019 = 78.75%
  - FY 2020 = 75.00%
  - FY 2021 = 71.25%
  - FY 2022 = 67.50%
  - FY 2023 = 63.75%
  - FY 2024 and after = residential rollback %
- The percentage of market value at which Section 42 property is currently assessed varies by property. A recent informal assessment survey found Section 42 properties with taxable values in a range of 20.0% to 75.0% of market value. The variation is likely caused by the difference in levels of rent subsidies. A contributing factor to the below-market value status of all Section 42 property could be the statewide capitalization rate used in the formula to establish taxable values. A capitalization rate that is too high will produce taxable values that are too low for market conditions.
- Adjusting the 20.0% to 75.0% range for the 90.0% commercial rollback that will benefit Section 42 housing classified as commercial by FY 2016, the range of taxable value to market rate value becomes 18.0% to 67.5%. This means that for FY 2016 and after, Section 42 housing taxed as commercial property will likely be subject to property tax under current law at 18.0% to 67.5% of its market value.
- The residential rollback percentages for future years are not known. Using assumptions based on past performance and current economic conditions, the Legislative Services Agency projects that the residential rollback will increase from its current level of 54.4% to 58.0% by FY 2020 and remain near that level through FY 2024.
- Based on the preceding assumptions, only Section 42 properties currently valued, after application of the 90.0% commercial rollback, above 58.0% of market value will benefit from opting out of the Section 42 assessment procedure. Properties valued under the special

Section 42 assessment procedure at 64.4% of market value will be taxed at 58.0% after application of the 90.0% commercial rollback (64.4% times 90.0% equals 58.0%).

- With the assumed current maximum taxable value percentage for Section 42 property at 75.0%, and the lowest assumed taxable value percentage that may benefit from opting out of Section 42 assessment at 64.4%, the number and value of properties that will choose to opt out is a small subset of the existing Section 42 properties in the State. All properties with an assessment percentage below 64.4% can be assumed to remain as commercial property for at least the next 10 years. For properties that may benefit from opting out, the first fiscal year that opting out will be financially beneficial is FY 2023. That is the first year when the multiresidential rollback (63.75%) falls below the assumed maximum Section 42 assessment percentage, adjusted for the commercial rollback (75.0% times 90.0% equals 67.5%).
- Based on the 67.5% assumed effective percent of market value that any Section 42 will be taxed at beginning in FY 2016, the maximum savings a Section 42 property can receive by opting out of the Section 42 assessment process is the difference between being taxed at 67.5% of market value and being taxed at 58.0% of market value. This is a property tax reduction of 14.1%.

#### *Section 42 Statistics*

- Over the past 15 years, Iowa has been allocated \$131.9 million in federal Low Income Housing Tax Credits, an average of \$8.8 million per year.
- From the period of 2011 through 2014, the Iowa Finance Authority has approved Section 42 tax credits equal to \$35.6 million for projects with a total of 3,112 qualified low income units. This equates to an annual federal tax subsidy of \$11,428 for 10 years per rental unit, or \$952 per unit per month. Therefore, excluding the value of the federal income tax credits from the taxable value calculation is likely to significantly reduce the average taxable value of Section 42 property when compared to market value.
- Concluding from the previous bullet, it is quite possible that Section 42 property is assessed well below market value. This Bill potentially impacts only Section 42 properties with a taxable value that exceeds the taxable value for multiresidential property. Those Section 42 properties assessed using the current Section 42 special assessment procedure and valued through that method at less than the expected multiresidential rollback can be assumed to remain as commercial property.

#### *General Assumptions for Estimate*

- Senate File 295 created a new class of property called multiresidential and that new class will be gradually reduced in taxable value until it is equal to the residential rollback rate for assessment year 2022 (FY 2024) and after.
- By assessment year 2018 (FY 2020), the residential rollback will equal 58.0%.
- This Bill will potentially benefit Section 42 property that is classified commercial and with a taxable value, after application of the special assessment procedure and the commercial rollback to 90.0%, above 58.0% of the property's market value. Property assessed at or below 58.0% of market value will choose to remain with the special Section 42 assessment procedure and therefore remain commercial property.
- For the fiscal note on SF 295, the assessed value of all multiresidential property in FY 2023 was estimated to equal \$6.027 billion. Section 42 housing will equal a subset of that amount, and the value that may benefit from this Bill is a much smaller subset.
- The statewide market value of commercial and industrial property is expected to grow after FY 2017, so unless property tax rates decline faster than the increase in commercial and industrial values, the annual State reimbursement to local governments will be prorated to some degree, beginning in FY 2018.

- If a Section 42 property chooses to opt out of the current special assessment procedure and qualifies under this Bill as a multiresidential property, the reimbursement to the specific local governments that tax that property may decrease, but the overall State reimbursement to local governments will not change. With less value to be reimbursed, the statewide proration percentage will increase in response.

#### *Maximum Opt-Out Tax Impact Assumptions*

- The first year any Section 42 property could financially benefit from conversion to the multiresidential class is expected to be FY 2023; the first year when the multiresidential rollback falls below the assumed benefit of being a property assessed as Section 42 and eligible for the commercial rollback.
- The statewide market and taxable value of Section 42 property is not known and cannot be estimated directly. The following information is used to develop the maximum taxable value implications.
  - The assessed value of all multiresidential property, including Section 42 property, is projected to be \$6.027 billion in FY 2023.
  - Assuming Section 42 property comprises 30.0% of all multiresidential property, Section 42 property statewide will total \$1.808 billion in FY 2023.
  - If 15.0% of all Section 42 value in FY 2023 can benefit from a conversion to multiresidential, the maximum statewide value that may benefit would be \$271.2 million. After application of the 90.0% commercial rollback, the impacted value is \$244.1 million.
  - The maximum benefit that a conversion will bring to Section 42 owners is a 14.1% reduction on \$244.1 million in value, or \$34.4 million in reduced taxable value.
- The average property tax rate in FY 2023 is not known. The average FY 2014 statewide property tax rate is \$37.64 for commercial property and that rate is used for the maximum impact calculation. Applying the \$37.64 per thousand tax rate to the maximum taxable valuation reduction of \$34.4 million, the maximum property tax savings for all Section 42 property opting out of the current assessment procedure is \$1.3 million per year, with the first year of any savings being FY 2023.
- For FY 2014, the average commercial property tax rate of \$37.64 can be broken down into average local government rates and using those rates the impact by government level can be estimated. The average tax rates in dollars per thousand of taxed value for FY 2014 equal:
  - Tax Increment financing = \$5.30
  - City rate = \$11.26
  - County rate = \$5.69
  - School rate, excluding uniform levy (\$5.40) = \$7.83
  - Remaining local governments = \$2.16
  - State General Fund (uniform levy) = \$5.40

#### **Fiscal Impact**

The statewide amount of Section 42 value that could benefit from the ability to opt-out of Section 42 assessment is not known. Each owner of Section 42 property will need to evaluate the future value of their properties on both a market basis and a Section 42 basis, and also project the future course of the residential rollback. An estimate of the maximum amount of value that could benefit was developed using the assumptions above, and a maximum fiscal impact was calculated. The actual fiscal impact is likely below the maximum impact. In all cases, the impact likely does not begin until FY 2023, when the stated rollback for multiresidential property first falls below the estimated highest effective taxed value rate for Sections 42 property when classified as commercial.

Using assumptions provided above, the maximum property tax reduction benefit provided in this Bill for Section 42 property is \$1.3 million, with the first year of any fiscal impact projected to be FY 2023. The projected maximum annual negative impact of the tax reduction, by government entity, is:

- Tax Increment financing = \$180,000
- City rate = \$390,000
- County rate = \$200,000
- School rate, excluding uniform levy = \$270,000
- Remaining local governments = \$70,000
- State General Fund (uniform levy) = \$190,000

If and when a Section 42 property opts out of the special assessment procedure and is converted to the multiresidential classification, local governments taxing that specific Section 42 property will see a reduction in their reimbursement payment from the State, as only the impact of the 90.0% rollback for commercial properties is part of the reimbursement calculation and the impact of any reduction due to the multiresidential classification is not reimbursed. However, the overall State appropriation level for reimbursements will not change. Therefore, the reimbursement loss for a specific local government will be offset by an overall increase for all local governments in the reimbursement proration rate.

### **Sources**

Department of Management property tax records  
Informal assessor survey of Section 42 property valuation  
Fiscal note for SF 295 – 2013 Session  
Iowa Finance Authority Section 42 awards  
Legislative Services Agency analysis

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/s/ Holly M. Lyons

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The fiscal note for this bill was prepared pursuant to [Joint Rule 17](#) and the Iowa Code. Data used in developing this fiscal note is available from the Fiscal Services Division of the Legislative Services Agency upon request.

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